Farm Partnerships

J. Stevenson

Factsheet

ORDER NO. 11-019 AGDEX 812 MARCH 2011
Replaces OMAFRA Factsheet 02-047, *Farm Partnerships*

INTRODUCTION

In Ontario, approximately 30 per cent of farms operate under a partnership arrangement. Many of these are family partnerships involving either children or a spouse, or business arrangements between unrelated parties.

This Factsheet is one in a series covering business structures that can be found on the OMAFRA website.

Contents

SECTION 1: THE BASICS OF PARTNERSHIPS

WHAT IS A PARTNERSHIP?

A partnership refers to a relationship where two or more persons carry on a business with a view to make a profit. Evidence of a partnership business structure may include:

- an agreement to share the profits and losses of a business
- formal registration as a partnership
- having the ability to bind each other contractually
- joint ownership of property
- the use of the words "partner" and "partnership" in any written documentation
- use of a partnership name, joint bank account, joint accounting and financing, etc.

WHY FORM A PARTNERSHIP?

Partnerships are formed for a variety of reasons, including:

- spouses who want to split income and reduce taxes
- bringing family members into the business either to allow a child to gain experience or to transfer a portion of the business
- unrelated parties that want to better utilize and reduce the cost of acquiring capital assets.

PARTNERSHIP AGREEMENTS

While a partnership agreement is not required for a partnership to exist it is strongly recommended. A properly drafted agreement establishes a statement of intention, clarifies the details of ownership and operation, and how disagreements between the partners will be resolved. Some items to include in a written partnership agreement are:

- asset ownership — who owns the assets
- accounting method chosen — cash or accrual
- selection of fiscal year-end date
- division of profits and losses and the reasons for the allocation. Note that partnership income need not be split according to a percentage basis only. For example one partner may take the first $30,000 of income while the remaining income may be split on a percentage basis
- when partnership income is to be allocated to partners
- how income will be allocated if a partner decides to leave the partnership during the year
- how disagreements will be solved, including the use of mediation
- the circumstances that allow the partnership to be dissolved
- the ability to buy out other partners, how it should be done and at what value
- if property has been transferred into the partnership at cost, to whom any taxable income will be allocated when any accrued gain is realized
- which partner(s) has the authority to act for the partnership in making elections under the *Income Tax Act*.

Table 1. Advantages and Disadvantages of Partnerships

Advantages	Disadvantages
Income splitting — With proper documentation and agreements, a partnership can be adapted to any family situation to allow for income splitting between spouses, between parents and children, between siblings or between non related parties.	**Legal liability for other partners —** A partner is not only liable for their own actions but is also jointly and 'severally liable' for the actions of all partners. Unlike a corporation where liabilities are limited to an individual's investment in the corporation and any guarantees provided, as a partner, all of the partner's assets outside the partnership are exposed to creditors' claims.
Intergenerational business transfer — The child can ease into the business, operate it jointly and then allow the parents to ease out. Sharing of responsibility and profits is possible. All tax deferral opportunities for a parent-child transfer are maintained.	**No protection from individual tax rates —** Compared to a corporation, a partnership does not provide any protection from the progressive rates of individual tax.
Lower costs — Partnerships are usually cheaper to establish and maintain than a corporation.	**More complex than a sole proprietorship —** Although partnerships are usually cheaper to establish and to maintain than a corporation, a partnership is a more complex arrangement than a sole proprietorship. Additional accounting information will have to be recorded each year so that the partners will be able to determine a tax value of their interest in the partnership as well as determine how profits are allocated.
Capital gains exemption — Any capital gains realized on the sale or transfer of a farm partnership interest may be eligible for the $750,000 capital gains exemption similar to shares of small business corporations.	**More complex record keeping —** While poor records are a disadvantage in any business arrangement, if good records are not kept in a partnership it is difficult to know who has contributed or withdrawn funds and who owns what assets. It can be especially difficult to wind-up a partnership with incomplete records.
Easier to dissolve — It is easier to dissolve a partnership than a corporation.	
Tax deferral provisions — Tax rules allow the transfer of assets to or from a partnership without incurring any immediate tax provided the rules are followed and forms filed.	

SECTION 2: FORMING A PARTNERSHIP

A partnership is often considered when the next generation wants to join the farming operation, spouses want to split income or siblings want to farm together. Some items to consider are listed below.

- Has the business relationship between the partners been tested by farming together in a less formal business structure such as a revenue sharing arrangement?
- Does the potential advantage of income splitting within a partnership outweigh the payment of wages to a spouse or child within a sole proprietorship?
- Will he business carry on for more than five years to ensure cost of forming the partnership is recouped?
- Does a partnership complement future goals? For example is incorporating the business a possibility?

COST TO FORM A PARTNERSHIP

It costs $2,000–$3,500 to set up a partnership and about $500–$1,000 more for annual accounting fees than a sole proprietorship.

Costs include a provincial fee of $60 and professional fees for legal and tax advice. The annual accounting cost is usually higher because of the additional financial statements. However, if the farm already has full financial statements, the added annual cost may not be significant.

ASSET OWNERSHIP

Partners may own assets — such as land, buildings, livestock, equipment or quota — both within and "outside" the partnership. The capital cost allowance (CAA), however, may only be claimed where the asset is held. For example, where a farmer personally owns buildings, it is the farmer, not the partnership, who claims the CCA for the buildings.

Assets Owned by Individuals Operating Within a Partnership

In this style of partnership the partners themselves own the assets. Capital cost allowance is claimed by the partners and not by the partnership. This type of partnership might be found in a spousal partnership where both spouses own the land and one spouse owns the production assets such as livestock, crops, supplies and equipment.

Table 2, *Partner Ownership,* shows an example of how a parent-child partnership of this type would report income (assuming income is split 50:50). In this example the parent has sold livestock to the child. The partnership splits net cash income prior to taking CCA. Each partner can deduct CCA from their share of net cash income if they chose.

Table 2. Ownership of Assets by Individuals within a Partnership

Partnership Income			
Cash Sales	$380,000		
Cash Costs	(280,000)		
Net Cash Income	$100,000		
Partner A (Child)		**Partner B (Parent)**	
Share of Income	$50,000	Share of Income	$50,000
Cattle Purchase	(25,000)	Cattle Sale	25,000
CCA.	(5,000)	CCA	(12,000)
Interest	(6,000)	Interest	(3,000)
Net Income	**$14,000**	**Net Income**	**$60,000**

Claiming CCA — A Potential Trap

It is important **not** to claim CCA at the partnership level if there is the assets are personal. If the proper election forms have not been filed, the Canada Revenue Agency (CRA) could view that as a fair market value sale to the partnership and require taxes paid on any capital gains, income or recapture.

Assets Owned by Partners and Partnership

In this style of partnership both the partners and the partnership own the assets. It is sometimes referred to as a "modified partnership". For example the partnership could own current inventory items like livestock, crops, and supplies. The partners could own land and fixed equipment. Breeding livestock, quota and moveable equipment could be owned by either the partners or the partnership. It is not unusual for partners to own existing assets outside of the partnership while new purchases are owned by the partnership. Both the partnership and the partners will take CAA for their respective assets.

This type of asset ownership is common in parent-child and sibling partnerships as it can give a child a share of ownership in the productive assets. Table 3, *Partners and Partnership Ownership,* shows an example of how the partnership would deduct CCA and share income (assuming a 50-50 split of net income).

Table 3. Partners and Partnership Ownership

Partnership			
Cash Sales	$110,000		
Cash Costs	(60,000)		
CCA	(10,000)		
Net Income	$40,000		
Partner A		**Partner B**	
Share of Income	$20,000	Share of Income	$20,000
Interest on Loans	(5,000)	CCA	(4,000)
Net Income	**$15,000**	**Net Income**	**$16,000**

Assets Owned by Partnership

In this style of partnership all of the assets are owned by the partnership. The partners only own a partnership interest and this interest can be transferred in whole or in part to a child. The CCA is claimed by the partnership.

Table 4, *Partnership Ownership,* shows how the income is shared. Note that the partnership deducts all of the capital cost allowance to determine net income. In this example the partnership income split is 60:40.

Table 4. Partnership Ownership

Cash Sales	$110,000
Cash Costs	(66,000)
CCA	(14,000)
Net Income	$ 30,000
Partner A's Share	$ 18,000
Partner B's Share	$ 12,000

This style of agreement is attractive to those who like the simplicity of having all the assets owned by the partnership. It also is easier to prepare comprehensive financial statements for lenders.

Regardless of what the partnership agreement may provide, when partnership business is being conducted, each partner is:

- an agent of the firm and
- financially responsible for the actions of the other.

Spousal Partnerships

Spousal partnerships can be advantageous for splitting income and the capital gains of assets. A partnership arrangement may also more truly reflect the contribution of both spouses to the business.

Canada Revenue Agency (CRA) may look closely at the profit sharing arrangements of non-arm's length partnerships (such as a husband and wife or children). If the CRA considers the allocation of income to be unreasonable it has the power to change it. CRA will look at both the time expended and the expertise provided by a partner. If a partner has special skills, more value can be attributed to such time and less involvement would be acceptable.

If one partner is not actively engaged in the business but contributes significant capital to the partnership, CRA examines the source of the capital. For example, if one spouse makes the capital contribution from funds received by a gift or loan from the other spouse, CRA might move to disallow income splitting with the non-active spouse. However, if the funds are loaned between spouses at reasonable interest rates, CRA will not challenge contributions made by the non-active spouse.

Determining a Spousal Partnership

In some cases spouses should clarify if they are currently a partnership. If the answers to all of the following questions are yes, then a spousal partnership likely exists.

- Did both spouses contribute original capital or make ongoing contributions of capital?
- Are both spouses registered on the ownership of assets?
- Can both spouses write cheques on the farm bank account?
- Do both spouses contribute labour and/or management to the farm business?

TAX IMPLICATIONS OF FORMING A PARTNERSHIP

This is intended as information only. Tax advice from an accountant familiar with farm partnerships is recommended.

ROLLOVER OF ASSETS TO A PARTNERSHIP

The *Income Tax Act* generally allows for the transfer of assets into a Canadian partnership on a tax-deferred basis. This is called a rollover. Under normal rules any transfer would take place at fair market value (FMV). Values can be set between the adjusted cost base for land, undepreciated capital cost for buildings or cumulative eligible capital for quota — and the FMV. To take advantage of this rollover an election must be filed at the time of transfer. It is a best practice to file this election, since it will prevent tax from being assessed in the case of an incorrect inventory valuation or where CRA might dispute the calculation of a FMV figure for real estate and substitute with a higher figure.

A proprietor may roll assets into a partnership at a value that triggers no tax or at a value that triggers enough income to use up previous losses. If the partner is only receiving a partnership interest as consideration for their assets they can elect at any value they choose. However, if the partnership is paying for part of the value of the asset by assuming the partner's debt or by owing an amount to the partner, the elected value cannot be less than the consideration received. This higher value may then trigger some tax. This would often be true in cases where a significant amount of debt is assumed by the partnership.

The following scenarios outline three different methods of establishing a partnership where parents and a child want to farm together in a partnership arrangement. These scenarios show various asset ownership styles and how assets would be transferred to form the partnership. The tables show the beginning position of each partner, the action taken with each asset and the final position after the partnership has been formed. A more detailed version of these tables, with the complete tax values included can be found in Appendix 1.

Scenario 1: Assets are owned personally by the partners, both before and after the partnership is formed. In order to establish an equal three-way partnership, each of the partners put in $5,000 cash. The father sells one half of the quota, machinery and inventory to the child for $225,000. The father holds a note as evidence of the debt. The result is a 1/3-1/3-1/3 partnership as shown in Table 5, *Scenario 1: Forming a Partnership.* Table 11 in the appendix contains the tax details.

Table 5. Scenario 1: Forming a Partnership

BEFORE						AFTER	
Assets	**FMV Value**	**Action Taken**	**Amount Sold to Child**	**Elected Transfer Value**	**FMV Value of Partshp Interest**	**FMV Value Personal Assets & Partshp Int.**	**Partshp %**
Father							
1/2 Land	300,000	keep ownership				300,000	
Quota	700,000	1/2 sold to child	100,000			350,000	
Buildings (Pt.XI)	200,000	keep ownership				200,000	
Machinery (Pt.XI)	100,000	1/2 sold to child	25,000			50,000	
Inventory	200,000	1/2 sold to child	100,000			100,000	
Cash	5,000	transferred to partshp		5,000	5000		
Partnership Interest						5,000	
Total	**1,505,000**			**5,000**	**5,000**	**1,005,000**	**33.3%**
Mother							
1/2 Land	300,000	keep ownership				300,000	
Cash	5,000	transferred to partshp		5,000	5000		
Partnership Interest						5,000	
Total	**305,000**			**5,000**	**5,000**	**305,000**	**33.3%**
Child							
Quota						350,000	
Machinery (Pt.XI)						50,000	
Inventory						100,000	
Cash	5,000	transferred to partshp		5,000	5000		
Partnership Interest						5,000	
Total	**5,000**		**225,000**	**5,000**	**5,000**	**505,000**	**33.3%**

Scenario 2: Assets are owned by both the partners and the partnership. As in scenario 1 each of the partners contributes $5,000 cash. However the father does not sell any assets to the child but rather transfers them directly to the partnership. The result is the partnership ownership is heavily weighted to the father. In this case the child might supply a larger portion of the labour and therefore receive a greater share of profits than the 0.5 per cent indicated by capital contributions alone. The partnership is shown in Table 6, *Scenario 2: Forming a Partnership*. Table 12 in the appendix contains the tax details.

Table 6. Scenario 2: Forming a Partnership

BEFORE						AFTER	
Assets	**FMV Value**	**Action Taken**	**Amount Sold to Child For**	**Elected Transfer Value**	**FMV Value Partshp Interest**	**FMV Value Personal Assets & Partshp Int.**	**Partshp %**
Father							
1/2 Land	300,000	keep ownership				300,000	
Quota	700,000	transferred to partshp		200,000	700,000		
Buildings (Pt.XI)	200,000	keep ownership				200,000	
Machinery (Pt.XI)	100,000	transferred to partshp		50,000	100,000		
Inventory	200,000	transferred to partshp		0	200,000		
Cash	5,000	transferred to partshp		5,000	5,000		
Partnership Interest						1,005,000	
Total	**1,505,000**			**255,000**	**1,005,000**	**1,505,000**	**99.0%**
Mother							
1/2 Land	300,000	keep ownership				300,000	
Cash	5,000	transferred to partshp.		5,000	5000		
Partnership Interest						5,000	
Total	**305,000**			**5,000**	**5,000**	**305,000**	**0.5%**

Table 6. Scenario 2: Forming a Partnership

BEFORE						AFTER	
Assets	**FMV Value**	**Action Taken**	**Amount Sold to Child For**	**Elected Transfer Value**	**FMV Value Partshp Interest**	**FMV Value Personal Assets & Partshp Int.**	**Partshp %**
Child							
Cash	5,000	transferred to partshp.		5,000	5000		
Partnership Interest						5,000	
Total	**5,000**			**5,000**	**5,000**	**5,000**	**0.5%**

Scenario 3: Here assets are owned by both the partners and the partnership after the partnership is formed. In this case the father sells his 1/2 share in the quota to the child and also transfers some other assets to the partnership. The child then transfers the newly acquired quota to the partnership. This creates a partnership where the child has the largest share of the partnership, while the parents still own a significant amount of the assets. The partnership is shown in Table 7, *Scenario 3: Forming a Partnership.* Table 13 in the appendix contains the tax details

Table 7. Scenario 3 — Forming a Partnership

BEFORE						AFTER	
Assets	**FMV Value**	**Action Taken**	**Amount Sold to Child For**	**Elected Transfer Value**	**FMV Value of Partshp. Interest**	**FMV Value Personal Assets & Partshp Int.**	**Partshp %**
Father							
1 /2 Land	300,000	keep ownership				300,000	
1/2 Quota	350,000	sold to child	100,000				
Buildings (Pt.XI)	200,000	keep ownership				200,000	
Machinery (Pt.XI)	100,000	transferred to partshp		50,000	100,000	100,000	
Inventory	200,000	transferred to partshp		0	200,000		
Cash	5,000	transferred to partshp		5,000	5,000		
Partnership Interest						305,000	
Total	**1,155,000**			**55,000**	**305,000**	**905,000**	**30.2%**
Mother							
1 /2 Land	300,000	keep ownership				300,000	
1/2 Quota	350,000	transferred to partshp		100,000	350,000		
Cash	5,000	transferred to partshp		5,000	5,000		
Partnership Interest						355,000	
Total	**655,000**			**105,000**	**355,000**	**655,000**	**35.1%**
Child							
1/2 Quota		transferred to partshp		100,000	350,000		
Partnership Interest						350,000	
Total	**0**		**100,000**	**100,000**	**350,000**	**350,000**	**34.7%**

SECTION 3: OPERATING THE PARTNERSHIP

CALCULATING A PROFIT SHARE

Partners should share the net income in a reasonable manner. If the partners are related the Canada Revenue Agency can change the allocation of income if it is deemed unreasonable.

DRAWINGS AND SALARIES

The important point to remember is that it is the partner's share of the partnership's earnings that gets reported as income for the year **not** the drawings that they choose to take. For example, if the partnership earned $100,000 and the partner whose allocation was 50 per cent would have an income of $50,000, regardless of the amount the partner actually withdrew from the partnership for that year. What the partners report from year to year will change as the profitability of the partnership changes or if the allocation formula is changed. The drawings, on the other hand, might stay the same from year to year.

Table 8, *Allocation of Income and Drawings,* shows an example of three partners each taking drawings from a partnership. The partnership split is 40-40-20. In the example, the drawings stay the same each year but the partnership income drops in the second year. Note that in year 1 the partners report more for tax than they actually drew. This means that the value of their partnership interest increased. In year 2 the opposite happens. Partners A and B reported less for tax than they drew out of the partnership and their partnership interest decreased in value. Partner C's drawings were the same as what was reported for tax.

Money left in the partnership (when drawings are less than the allocation) can be used for financing operations, loan repayments or capital purchases. In the example in Table 8 at the end of year 1 there was $5,000 remaining in the partnership. This was income generated by the partnership but not drawn out by the partners. That drops to $0 at the end of year 2 because partners A and B drew out more money than the partnership made or allocated that year.

A partner's salary is not a business expense of a partnership but rather is part of the profit distribution formula. Table 9, *Calculating Partnership Income,* shows how the incomes of two partners would be calculated in three different years. Partner A in this example provides most of the labour and therefore draws the first $20,000 from the partnership. The remaining income is then split on a 50-50 basis between the partners.

Notice in year 2 the partnership income does not cover the $20,000 of wages of partner A and results in a $2,000 loss. This loss would be divided between the partners. Partner A would report $19,000 (20,000–1000) for tax and Partner B would report a loss of $1,000.

Table 8. Allocation of Income and Drawings

		Partner A	Partner B	Partner C
Percent of Income allocated		40%	40%	20%
Year 1				
Net Partnership Income	65,000			
A. Income Allocation (reported for tax)		26,000	26,000	13,000
B. Drawings for the Year 1		25,000	25,000	10,000
C. Partnership Interest Change (A–B)		1,000	1,000	3,000
Year 2				
Net Partnership Income	50,000			
D. Income Allocation (reported for tax)		20,000	20,000	10,000
E. Drawings for the Year 2		25,000	25,000	10,000
F. Partnership Interest Change (D–E)		(5,000)	(5,000)	—
Cumulative Partnership Interest Change (C+F)		(4,000)	(4,000)	3,000

Table 9. Calculating Partnership Income – based on one partner allocated first $20,000 of income

	Year 1	Year 2	Year 3
Partnership Income	50,000	18,000	(5,000)
Partner A's allocation of first $20,000 of partnership income	20,000	20,000	20,000
Net Income of Partnership – allocated 50:50 to the partners	30,000	(2,000)	(25,000)
Income Reported by Partners			
Partner A			
Allocation of first $20,000 of partnership income	20,000	20,000	20,000
Allocation of remainder of partnership income (50%)	15,000	(1,000)	(12,500)
Partnership Income to be Reported for tax purposes	35,000	19,000	7,500
Partner B			
Allocation of remainder of partnership income (50%)	15,000	(1,000)	(12,500)
Partnership Income to be Reported for tax purposes	15,000	(1,000)	(12,500)

EMPLOYMENT INSURANCE

Employment Insurance benefits can be affected by partnership income. If a partner is employed off the farm, they may have to contribute to EI. If the partner working off the farm became unemployed, they may not be able to collect EI benefits because the partnership income is considered another source of income.

HOW IS A PARTNERSHIP TAXED?

A partnership is not a separate legal entity like a sole proprietor or a corporation. As a result the partners report the net income of the partnership and their share is taxed in their hands.

Partnership Financial Statements

A partnership must prepare an Income Statement for tax purposes. Although a balance sheet is not required it is highly recommended. Preparing a balance sheet each year will document how much each of the partners has contributed and withdrawn from the partnership, which is important in calculating the value of each partners interest. The value of each partner's partnership interest is essential for an equitable dissolution of the partnership should that ever take place.

A Partnership Interest

The equity or ownership that a partner has in a partnership is called a partnership interest. A partnership interest is considered capital, just as shares are or ownership of land. It has a tax value called the adjusted cost base (ACB) and a fair market value. A partnership interest can increase in value resulting in a capital gain or lose value creating a loss. An interest in a family farm partnership is eligible for the $750,000 capital gain exemption.

An individual who purchases a partnership interest cannot use any personal tax deductions for the underlying assets such as livestock, quota or equipment. These deductions are used by the partnership. If the purchaser uses debt capital to buy a partnership interest, the interest payments are an expense deducted on their personal tax return. It is not an expense of the farm business.

If a partnership disposes of its assets instead of a partner selling an interest, the tax rules relating to each type of asset will apply. The funds flow through to the partner as either revenue or capital gain. The capital gain exemption of each partner can be used to offset any capital gain for assets that qualify.

SECTION 4: TRANSFERRING THE PARTNERSHIP TO THE NEXT GENERATION

TRANSFER OF A PARTNERSHIP INTEREST

Many farm partnerships are transferred to the next generation. Before transferring a partnership interest determine the adjusted cost base of the partnership interest. If the partnership has existed for some time original documentation in addition to past partnership financial statements are needed to arrive at the appropriate transfer values.

Farm assets owned by individual partners transfer using the normal tax rules. For details on these refer to the OMAFRA Factsheet Order No. 09-015, *Taxation on the Transfer of Farm Business Assets to Family Members.*

Calculating the Adjusted Cost Base of a Partnership Interest

The tax value of a partnership interest is called the adjusted cost base (ACB). The opening adjusted cost base for a partner is the sum of the elected value of assets rolled into a partnership and cash invested in the partnership.

The partnership and partner's annual activities will adjust the cost base of the partnership interest. The ACB of a partner's partnership interest is increased by:

- a partner's share of profits
- added capital contributions
- the partner's share of the non taxable portion of capital gains or eligible capital property

The ACB of a partner's partnership interest is reduced by:

- a partner's share of losses
- personal withdrawals from the partnership
- partner's share of the non-deductible portion of capital losses realized by the partnership
- partner's share of charitable and political donations made by the partnership
- investment tax credits deducted by the partner which were allocated by the partnership

It is possible to have a negative adjusted cost base when drawings exceed profits. This negative ACB is a potential capital gain that goes unrecognized until the partnership interest is transferred.

The Rollover of a Partnership Interest to a Child

An interest in a family farm partnership can be transferred to a child on a tax deferred basis provided

that substantially all the property was principally used in the business of farming by a partnership in which the person, their spouse or their child was actively engaged. This allows the partnership interest to be transferred at any value between ACB and the FMV. If the ACB is negative the ACB will be deemed to be nil and the negative amount included as income to the parent.

Capital Gain Exemption on a Partnership Interest

In order to qualify for the $750,000 capital gain exemption, the partnership interest must be qualified farm property. The definitions of qualified farm property are contained in the OMAFRA Factsheet Order No. 08-047, *Taxation of the Sale of Farm Business Assets.*

For the purposes of the capital gains exemption, the partnership need not carry on the business of farming itself. The individual partner, spouse, children, parent or the beneficiary of a personal trust may use the partnership's property in the business of farming. Throughout a period of at least two years, more than 50 per cent of the value of the partnership's assets must represent property that was used principally in the business of farming in Canada and the partner, spouse, child or parent must have been actively engaged in that business on a regular and continuous basis. At the time of the sale of the partnership interest, at least 90 per cent of the value of the partnership's assets must represent property that was used principally in the business of farming in Canada.

Choosing a Price

Because of the rollover rules allowed on a partnership interest, there is a great deal of flexibility in choosing a sale price. The sale price can be anywhere between zero and fair market value (FMV) because there is no gift tax in Ontario. Any value at or below ACB avoids all capital gains. A price above the ACB and up to and including the FMV would trigger some or all of the capital gains. The capital gain would be eligible for the $750,000 capital gain exemption if available.

Table 10, *Transfer Values of a Partnership Interest* is an example of a partnership interest with a FMV of $500,000 and an ACB of $100,000. Four different transfer values are used in the example, $0, the ACB, one-half FMV value and the FMV.

Table 10. Transfer Values of a Partnership Interest

	Gift	**Tax Value**	**Half Value**	**FMV**
FMV	$500,000	$500,000	$500,000	$500,000
Tax Value (ACB)	100,000	100,000	100,000	100,000
Transfer Price	**0**	**100,000**	**250,000**	**500,000**
Deemed Proceeds	100,000	100,000	250,000	500,000
Capital Gain for Parent	0	0	150,000	400,000
Tax Value for Child	100,000	100,000	250,000	500,000
Child Owes Parent	0	100,000	250,000	500,000
Child's Equity	100%	80%	50%	0%

Creating a Capital Gain Reserve

If the capital gain exemption was not available, consider holding a note payable in order to be eligible for a capital gain reserve. The capital gain reserve allows the parent to spread capital gain over five years on a sale to an arms-length party or over 10 years on the sale to a child. It might also help avoid the alternative minimum tax on a larger sale where the capital gain exemption is used.

DEATH OF A PARTNER

A partnership interest can be willed to a child so the transfer occurs at the ACB, postponing capital gains. The executor of the estate can also elect to trigger the capital gain, use up the remaining capital gain exemption and give a child a higher starting ACB.

Include a special clause in the partnership agreement that allows the partnership to carry on upon the death of a partner. Without this clause a two-person partnership ceases upon the death of one of the partners. In most cases it is best to have at least three partners so that two can carry on if one should die. For example include both parents and child.

RETIREMENT OF A PARTNER

A partnership may cease when a partner retires. Consider adding a clause that allows for the continuation of the partnership in this event.

The *Income Tax Act* allows a retiring partner to continue to receive a share of partnership profit and losses. Such profits are considered as income to the retired partner and a deduction for the partnership. The right to such profits could continue to beneficiaries of the retiring partner.

This can be a way of assuring some continuing income to a retired parent who has transferred their ownership to

children on preferred terms. The children must remember the preference they received when profits continue to be shared with someone who is inactive.

INCORPORATING A PARTNERSHIP

Partnerships have the option of incorporation. The business may be generating enough profit to take advantage of the lower corporate tax rates, the partners might want to limit their liability or they may want to use some of the capital gains exemption available to them. There are two methods to incorporate a partnership.

Incorporation, Followed by a Wind-Up of the Partnership

Partnership property may be transferred to a corporation in exchange for shares. The transfer of property must be to a taxable Canadian corporation, consideration must include at least one share of the capital stock of the corporation, and the elected amounts of the assets transferred can be an amount between the cost amount and the FMV amount of the asset. The partnership may not make an election on real property (e.g., real estate) that is inventory. In addition, if inventory such as cattle is transferred under these provisions, any resulting income is subject to income inclusion rather than capital gains treatment.

Once the transfer of partnership assets to the corporation is complete, the partnership must be wound-up within 60 days in order for the partners to receive their shares of the corporation from the partnership on a tax-deferred basis. In order to have the tax deferral apply the only assets the partnership can hold immediately before the wind-up are money and property received from the corporation as consideration for the disposition of assets.

Incorporation, Followed by a Wind-up of the Partnership into the Company

Instead of incorporating the partnership property, the actual partnership interest can be transferred to the corporation and the partnership dissolved. An election can be used to limit the amount the capital gain that otherwise would result by electing at an appropriate amount between the ACB and the FMV. Note however, that if the ACB of the interest is negative, a capital gain will result since the minimum elected amount is $1.

To be eligible for the rollover the *Income Tax Act* states that within three months a former partner must continue in the business and use some of the partnership property. This means the transfer to the corporation must be staggered so that the corporation can be considered a "former partner." If all partnership interests are transferred to the corporation at once, the partnership will cease to exist and the election may not apply to the partnership. In practice one partner would transfer their partnership interest first, then after an appropriate period of time the second partner could transfer theirs and the partnership would be dissolved. This ensures the corporation will be considered a partner of the partnership at some point in time.

SECTION 5: DISSOLVING THE PARTNERSHIP

TERMINATION OF A PARTNERSHIP

Partnerships can terminate when one party assumes the business, when a partner dies, when partners decide to go their separate ways or when a corporation is formed. Apart from the various rollover provisions in the *Income Tax Act* the partnership property transferred to the partners is deemed to transfer at fair market value. To qualify for the rollovers, specific dates may need to be observed and in some cases election forms must be filed. Obtain reliable tax advice so that these provisions are not inadvertently lost through the actions of one or more of the partners.

CARRY ON AS A PROPRIETOR

When one party purchases the partnership interest of the other partner(s) and carries on as a sole proprietor, the tax liability of the continuing partner is postponed. They are permitted to continue without incurring tax at the time of the dissolution of the partnership. However, the partner who is leaving has a disposition of their partnership interest subject to capital gains unless it is a parent-child transfer at a reduced price. No election for this postponement of tax is required. This deferral comes into force automatically if one partner carries on the business using some or all of the former partnership assets. The tax cost of the assets for the continuing sole proprietor is a combination of their share of the cost to the partnership and the proportionate cost of the partnership interest purchased from the exiting partner.

DEATH OF A PARTNER

The death of one partner in a two party partnership causes the termination of a partnership. Provision may be made for the agreement to carry on to the end of the business year. If the surviving partner carries on as a proprietor, the partnership will not have a deemed disposition of assets. Rather, the partners have disposed of their interests. There is a rollover available from a parent to a child. The tax cost to the continuing

proprietor combines the tax value of assets and the partnership interests.

WIND UP AND SPLIT

The *Income Tax Act* allows for the wind-up of a partnership with a rollover of assets to individual partners. To apply all partners must file the election for the rollover. The partnership must cease to exist and all partnership assets must be distributed in such a manner that each party has an "undivided interest" in each asset. Generally such a wind-up will result in a tax-free rollover; however in some cases there can be a taxable capital gain. This wind-up provision is a major advantage over corporations. Take care to ensure all partners understand the rollover rules and do not negate the rollover by commencing business within three months.

Although being able to transfer assets out of the partnership on a tax deferred basis is one of the advantages of a partnership, the partners now own an undivided interest in the former property of the partnership with all the other partners. If the partners truly want to go their separate ways, additional transactions will be needed to ensure partners have sole interests in assets. CRA has stated that where a property is partitioned between its joint owners in such a way that each owner preserves the same share of the FMV of the property held before the partition, the partition is not considered a disposition for tax purposes.

Any additional transactions, such as selling the interest in an individual asset that do not meet the CRA criteria must be done at FMV and can result in capital gains or recapture that the partners tried to avoid by using the rollover. Some of this capital gain and recapture may be deferred by using the replacement property rules.

SUMMARY

Partnerships are very flexible arrangements for farm families who want to split income, allow the entry of children into the business and ultimately transfer the business assets to the next generation. The development of an appropriate partnership agreement requires that family members discuss their goals and preferences with each other before entering into a partnership arrangement. Doing so will strengthen the ability of the business partnership to function smoothly and effectively in the years ahead.

This factsheet was updated by Jennifer Stevenson, Business Finance Program Lead, OMAFRA, Guelph. It was originally written by Rob Gamble, former Finance and Business Structures, Program Lead, OMAFRA, Guelph with the assistance of Ed Mitukiewicz, CA, Collins Barrow, Elora, Ontario.

Appendix 1. Detailed Tax Calculations

The following tables contain the detailed tax calculations involved in the transfer scenarios outlined in Section 2.

Table 11. Scenario 1: Detailed Tax Calculations

BEFORE				TRANSFER DETAILS				AFTER		
Assets	**ACB (UCC or CEC)**[1]	**FMV Value**	**Action Taken**	**Amount Sold to Child For**	**Elected Transfer Value**	**Tax Value of All Assets**	**Tax Cost of Partnership**	**FMV Value of Partshp Interest**	**FMV Value of Personal Assets & Partshp Interest**	**Partshp %**
Dad										
1/2 Land	70,000	300,000	keep ownership			70,000			300,000	
Quota *	150,000	700,000	1/2 sold to child	100,000		75,000			350,000	
Buildings (Pt.XI)	60,000	200,000	keep ownership			60,000			200,000	
Machinery (Pt.XI)	50,000	100,000	1/2 sold to child	25,000		25,000			50,000	
Inventory	0	200,000	1/2 sold to child	100,000					100,000	
Cash	5,000	5,000	transfer to partshp		5,000			5000		
Partship Interest						5,000	5,000		5,000	
Total	**335,000**	**1,505,000**			**5,000**	**235,000**	**5,000**	**5,000**	**1,005,000**	**33.3%**
Mom										
1 /2 Land	70,000	300,000	keep ownership			70,000			300,000	
Cash	5,000	5,000	transfer to partshp		5,000			5000		
Partshp Interest						5,000	5,000		5,000	
Total	**75,000**	**305,000**			**5,000**	**75,000**	**5,000**	**5,000**	**305,000**	**33.3%**
Child										
Quota						**75,000**			**350,000**	
Machinery (Pt.XI)						25,000			50,000	
Inventory									100,000	
Cash	5,000	5,000	transfer to partshp		5,000			5000		
Partshp Interest						5,000	5,000		5,000	
Total	**5,000**	**5,000**		**225,000**	**5,000**	**105,000**	**5,000**	**5,000**	**505,000**	**33.3%**

[1] The assumptions made for the transfer and sale prices of quota were that the CEC was $150,000; the 1971 value was 0.

Table 12. Scenario 2: Detailed Tax Calculations

BEFORE				TRANSFER DETAILS				AFTER		
Assets	**ACB (UCC or CEC)[1]**	**FMV Value**	**Action Taken**	**Amount Sold to Child For**	**Elected Transfer Value**	**Tax Value of All Assets**	**Tax Cost of Partnership**	**FMV Value of Partshp Interest**	**FMV Value of Personal Assets & the Partshp Interest**	**Partshp %**
Dad										
1 /2 Land	70,000	300,000	keep ownership			70,000			300,000	
Quota *	150,000	700,000	transfer to partshp		200,000	Transferred	200,000	700,000		
Buildings (Pt.XI)	60,000	200,000	keep ownership			60,000			200,000	
Machinery (Pt.XI)	50,000	100,000	transfer to partshp		50,000	Transferred	50,000	100,000		
Inventory	0	200,000	transfer to partshp		0	Transferred	0	200,000		
Cash	5,000	5,000	transfer to partshp		5,000		5,000	5,000		
Partship Interest						255,000			1,005,000	
Total	**335,000**	**1,505,000**			**255,000**	**385,000**	**255,000**	**1,005,000**	**1,505,000**	**99.0%**
Mom										
1 /2 Land	70,000	300,000	keep ownership			70,000			300,000	
Cash	5,000	5,000	transfer to partshp		5,000			5000		
Partship Interest						5,000	5,000		5,000	
Total	**75,000**	**305,000**			**5,000**	**75,000**	**5,000**	**5,000**	**305,000**	**0.5%**
Child										
Cash	5,000	5,000	transfer to partshp		5,000			5,000		
Partship Interest						5,000	5,000		5,000	
Total	**5,000**	**5,000**			**5,000**	**5,000**	**5,000**	**5,000**	**5,000**	**0.5%**

[1] The assumptions made for the transfer and sale prices of quota were that the CEC was $150,000; the 1971 value was 0.

Table 13. Scenario 3: Detailed Tax Calculations

BEFORE				TRANSFER DETAILS				AFTER		
Assets	**ACB (UCC or CEC)(1)**	**FMV Value**	**Action Taken**	**Amount Sold to Child For**	**Elected Transfer Value**	**Tax Value of All Assets**	**Tax Cost of Partnership**	**FMV Value of Partshp. Interest**	**FMV Value of Personal Assets & the Partshp. Interest**	**Partshp %**
Dad										
1 /2 Land	70,000	300,000	keep ownership			70,000			300,000	
1/2 Quota *	75,000	350,000	Sold to Child	100,000		sold				
Buildings (Pt.XI)	60,000	200,000	keep ownership			60,000			200,000	
Machinery (Pt.XI)	50,000	100,000	transfer to partshp		50,000	transferred		100,000	100,000	
Inventory	0	200,000	transfer to partshp		0	transferred	0	200,000		
Cash	5,000	5,000	transfer to partshp		5,000			5,000		
Partship Interest						55,000	5,000		305,000	
Total	**260,000**	**1,155,000**			**55,000**	**185,000**	**5,000**	**305,000**	**905,000**	**30.2%**
Mom										
1 /2 Land	70,000	300,000	keep ownership			70,000			300,000	
1/2 Quota	75,000	350,000	transfer to partshp		100,000	transferred	100,000	350,000		
Cash	5,000	5,000	transfer to partshp		5,000			5,000		
Partship Interest						105,000	5,000		355,000	
Total	**150,000**	**655,000**			**105,000**	**175,000**	**105,000**	**355,000**	**655,000**	**35.1%**
Child										
1/2 Quota			transfer to partshp		100,000	transferred	100,000	350,000		
Partship Interest						100,000	5,000		350,000	
Total	**0**	**0**		**100,000**	**00,000**	**100,000**	**105,000**	**350,000**	**350,000**	**34.7%**

[1] The assumptions made for the transfer and sale prices of quota were that the CEC was $150,000; the 1971 value was 0.

FOR YOUR NOTES

Centre d'information agricole :
1 877 424-1300
Courriel : ag.info.omafra@ontario.ca
Bureau régional du Nord de l'Ontario :
1 800 461-6132

www.ontario.ca/maaaro

POD
ISSN 1198-7138
Also available in English
(Order No. 11-020)

* 1 1 - 0 1 9 *